13 July 2010

Mr Robert Wright
General Manager
Access Operations & Pricing Branch
Communications Group
Australian Competition and Consumer Commission
By email

Dear Robert

Review of Access Pricing Principles for Fixed Line services

As you will be aware, on 20 June NBN Co and Telstra announced that they had agreed a Financial Heads of Agreement ("the agreement") which provides both for NBN Co to access Telstra infrastructure and for the progressive migration of customers from Telstra's copper and cable access networks to the National Broadband Network ("NBN").

Whilst this agreement will clearly interest the ACCC in terms of its impact on the future access arrangements on the NBN, it also has important ramifications for the ACCC's current review of the Access Pricing Principles for Fixed Line services. First, this agreement has implications for the appropriate starting valuation of Telstra's fixed line assets, which is a core component of the ACCC's review. Second, the ongoing payments Telstra will receive under the agreement will impact on ongoing access prices, in particular the "return of capital" component of prices. Determining the correct way to account for these payments in the context of the new fixed line regulatory regime will be a central issue in the review.

This letter provides some initial perspectives from Optus on this transaction and how it should influence the ACCC's consideration of the Fixed Line Access Pricing Principles. In simple terms, Optus will contend that the more Telstra receives from NBN Co, the less it will require from access prices. The ACCC must guard against the risk that Telstra will recover its costs twice over if the agreed compensation payments are not properly taken into account.

Before turning to the issues, it is important to summarise what we know about the proposed arrangements under the agreement. It has been reported that Telstra will receive payments with a net present value of $9 Billion to provide for;

- The use by NBN Co of suitable Telstra infrastructure, including access to Telstra's pits, ducts, backhaul fibre and exchange buildings, as NBN Co starts to rollout its new network. We understand that access to such infrastructure will be provided for on the basis of a long-term lease[1]; and

[1] Transcripts of Telstra NBN conference call 21 June 2010, page 18. David Thodey said in response to a question on the lease "Look I can assure you its way outside any terms that you or I or any of our businesses would consider. You know it's a long term contract".

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- The progressive migration of customers from Telstra's copper and pay-TV cable networks to the new network to be built and operated by NBN Co.

Based on the information available to date, Optus has the following observations to make on the transaction.

First, given that the agreement was voluntary, the value Telstra placed on its own network cannot have been any greater than the sum it is to receive in exchange for shutting it down. In fact Telstra's valuation for its access network must be considerably less than $9 billion, since a proportion of that figure relates to backhaul fibre and exchange buildings.[2]

It follows that the ACCC should place very little weight on the replacement cost-based valuations for the network which have been proposed by Telstra. It is clear that Telstra has accepted a valuation for access to its assets that is well below the current replacement cost of those assets. In fact, Optus submits that the valuation of the assets appears to be consistent with the historic depreciated value of the assets. We note that the Historic Depreciated value of Telstra's Customer Access Network is $7.9 Billion[3] (this amount would not include the value of Telstra's backhaul network and its exchange buildings). Given this fact it would be inappropriate for the ACCC to value these same assets on a full replacement cost basis when setting current access prices. In fact this transaction provides a very strong signal for the ACCC to adopt a depreciated actual cost ("DAC") value for Telstra's assets.[4]

Access prices based on a DAC valuation for Telstra's network would be linked to actual costs incurred, as Optus contended in its submission. Such prices would enable investors in Telstra to recoup the full cost of investment – including a fair return on capital – but no more.

However, to prevent Telstra from recovering an amount *in excess* of a fair return, the ACCC must consider not only past compensation, but also the future. Whilst Telstra proposes to progressively de-commission its copper assets as it migrates customers to the NBN over an eight to ten year period, it will receive substantial compensation for those assets. In addition, it will receive a stream of revenue over a longer period for NBNCo's use of access network infrastructure including pits and ducts. Optus submits that both payments must be taken into account by the ACCC in setting access prices for the remaining life of Telstra's network.

How should the payments be taken into account? The answer is simple: all of the payments Telstra is to receive under the agreement represent a "return of capital" to its shareholders. Regardless of how the payments are described, the substance of the arrangement is Telstra's shareholders are to be compensated for their investment in the access network. Both the payments for migration and the ongoing payments for rental of duct and pit infrastructure are alternative means for Telstra to recover its costs, over and above wholesale access revenue.[5] In order to properly measure the impact of these payments, the ACCC will need to record the payments as they are received by Telstra, and reduce the level of the Regulatory Asset Base

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[2] Backhaul fibre and exchange buildings do not form part of the access network.

[3] Refer to ACCC's "Assessment of Proposals for National Broadband Network Process – Report to Expert Panel Jan 2009", page 59.

[4] The DAC value of the network is the original cost of rollout, adjusted for the proportion of those costs of investment that Telstra has already recovered (past compensation).

[5] There is also a strong argument that the elements of the agreement which concern the Government's commitment to relieve Telstra of its obligations under the Universal Service Obligation framework constitute a return of capital to Telstra's shareholders which should be netted off the Regulatory Asset Base. The value of this commitment to Telstra's shareholders has reportedly been estimated by Telstra at $2 billion.

accordingly. Over the duration of the agreement, it is likely that 100% or more of the outstanding capital invested by shareholders will be returned through these payments.

What does this mean for wholesale access prices? Effectively, access prices over the next 8 to 10 years will not need to include *any* allowance for "return of capital". Whilst there are a number of alternative paths for access prices consistent with this insight,[6] the crucial pricing principle for the ACCC is clear: Telstra must not recover through access prices any capital costs which it will recover through compensation from NBN Co. To do otherwise would result in end-users effectively compensating Telstra's shareholders for their investment twice over: once through the compensation payments from NBN Co[7], and again through fixed line access prices received by Telstra over the next 8 to 10 years.

In conclusion, fixed line access prices should be expected to fall as a result of this agreement. Since Telstra will receive additional revenue streams under the agreement, it will require a substantially *lower* level of revenue from wholesale access prices over the remaining life of its network.

The ACCC's review of fixed line pricing principles is timely: it provides an opportunity to carefully consider the implications of the agreement and adjust access prices accordingly. Taking proper account of compensation payments through lower access prices will not only respect Telstra's legitimate business interests; it will also drive increased competition and more efficient utilisation of the copper access network in its final years of operation.

I trust that the ACCC will give careful consideration to the comments Optus has provided in this letter. If you wish to discuss this matter further, please do not hesitate to contact me.

Yours sincerely

Andrew Sheridan
General Manager,
Interconnect & Economic Regulation

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[6] One possible resulting path for access prices would be an increasingly steep decline over the next 6 to 8 years as migration payments to Telstra increase in value. In practice, however, the ACCC may consider a flat path for access prices to be more desirable, and achieve that path by adjusting the depreciation schedule. This would imply an immediate decline in access prices which would then remain flat until the network is decommissioned.

[7] The compensation payments will be funded through taxation or alternatively through future access prices on the NBN. Either way, end users pay Telstra twice for the same costs.